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Distressed company mergers and acquisitions—tax considerations

Private equity liquidity can play a significant role during an economic downturn

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Background

Distressed companies often need to raise financing, restructure debt or even engage in an outright sale or liquidation of the business. Many private equity funds have dry powder—available cash—to make strategic investments in these types of businesses. Such an investment is often critical to the distressed business by enabling it to remain afloat and retain its employees, while providing a healthy return for the PE fund. However, an acquisition of a distressed business is often more challenging than a traditional M&A transaction from both a deal and tax perspective.

A distressed acquisition may occur in a traditional asset or equity acquisition, but could also involve a multistep transaction where the fund acquires new or existing debt of the company followed in short order by a swap into equity, a transaction sometime referred to as a loan-to-own transaction. As with any M&A transaction, the value of the tax attributes acquired (the tax shield) in a distressed business acquisition can be significant; however, those attributes may entail more risk in a distressed company context.

A critical determination in the acquisition of a distressed business is whether the acquisition occurs through a bankruptcy process or an out-of-court workout. Tax is generally not the driving factor of whether to enter into bankruptcy, but the tax ramifications of the acquisition will vary depending on both the structure of the transaction and whether a bankruptcy filing is involved. The most beneficial transaction structure will depend on the company's particular facts; it is not a one-size-fits-all analysis. A clear picture of the facts and tax consequences at the outset of the acquisition can help position the company more favorably moving forward.

Also note that companies choosing the bankruptcy route often structure it through a prepackaged section 363 asset sale (referring to section 363 of the Bankruptcy Code). Although this transaction appears to represent an asset sale, it is not necessarily treated as an asset sale for tax purposes.

Types of distressed acquisitions

The primary acquisition type discussed in this white paper involves an acquisition of debt with a subsequent swap into equity. However, many of the same tax considerations exist in any distressed business acquisition.

Significant income tax consequences, such as cancellation of debt income (CODI), often occur for the debtor company. Where the loan-to-own acquisition involves acquisition of existing as opposed to new debt, there is often a discount paid for the debt. If the debt purchaser is related to the debtor company, CODI for the debtor is triggered by a discounted debt purchase. If the debt purchaser is unrelated to the debtor, the CODI generally results upon the subsequent swap of debt for equity. In addition, a discharge or reduction of other debt and liabilities often occurs during the process, potentially leading to additional CODI. As is discussed in more detail below, any attribute reduction that occurs as a result of a CODI event generally reduces the value of the tax shield acquired with the company.

A loan-to-own transaction may represent any of the following transactions from a federal income tax perspective:

1. A taxable acquisition of assets outside of bankruptcy
2. An acquisition of equity outside of bankruptcy
3. A taxable acquisition of assets under Chapter 11 of the Bankruptcy Code (or a similar provision) such as a section 363 sale

4. A Chapter 11 bankruptcy where the debtor company emerges from bankruptcy
5. A Chapter 11 bankruptcy involving a new company acquiring the assets of the business that is a successor for tax purposes

While these transactions look very similar (i.e., they all involve the acquisition of debt and subsequent swap for equity), they often provide significantly different tax results. The intent of the analysis that follows is to highlight certain tax issues and differences in results depending upon the tax treatment of the acquisition.

Where the acquisition involves a C corporation and falls under transaction form 2, 4 or 5 above, CODI incurred in the transaction may require application of the rules providing exclusion of CODI from income, as well as rules for attribute reduction, thereby reducing the potential tax shield available following the acquisition. Transaction forms 1 and 3, on the other hand, represent taxable acquisitions of assets by a new entity with a fair market value (FMV) tax basis in the acquired assets and no carryover attributes. In general, before entering into a transaction, a buyer should perform an analysis to determine the type of transaction that provides the most valuable tax shield going forward.

In situations where the target corporation (or a successor) and its tax shield survive the reorganization, there is a high likelihood that excludable CODI will result. This is true for both a bankruptcy acquisition and an out-of-court acquisition transaction.

Exclusion of income from debt cancellation

CODI is excluded from a bankrupt or insolvent corporation's gross income for U.S. federal income tax purposes.[1] In nonbankruptcy situations, the exclusion is limited to the amount of the taxpayer's insolvency.[2] For purposes of section 108, insolvency is determined by the amount that the taxpayer's liabilities exceed the FMV of the taxpayer's assets, determined immediately before the discharge.[3] If CODI is triggered in bankruptcy, section 108 provides for a full exclusion from the corporation's income without an insolvency limitation.

Reduction of tax attributes

A corporation that excludes CODI due to either bankruptcy or insolvency is required to reduce tax attributes, such as net operating loss (NOL) carryforwards, tax credits and assets' tax basis. Sections 108(b) and 1017 provide corresponding rules that act to reduce the taxpayer's basis in property owned at the beginning of the year following the discharge, generally by the amounts excluded from gross income under section 108.[4]

NOL carryforwards are attributes subject to this reduction rule. At the same time, section 382, which generally operates to limit the utilization of corporate NOLs and built-in losses following an ownership change, provides taxpayers undergoing bankruptcy with favorable rules for the utilization of NOLs upon emergence from the bankruptcy proceeding.[5] As a result, understanding the consequences of the interplay between attribute reduction and the section 382 limitation is critical to taxpayers contemplating bankruptcy. Note that the IRS and Treasury have proposed rules that, if finalized, would significantly curtail the value of acquired NOLs and would likely result in restructuring of the acquisition. For further details on the proposed regulations please see our article, Proposed regulations would decrease acquisition value of tax losses.

Unless the taxpayer elects otherwise, attribute reduction occurs in the following order:

1. NOLs
2. General business credits
3. Minimum tax credits
4. Capital loss carryovers
5. Basis in property of the taxpayer
6. Passive activity loss and credit carryovers
7. Foreign tax credit carryovers[6]

The amount of attribute reduction is not affected by the limitation on utilization of the attribute under prior section 382 limitations. As a result, even NOLs that will never provide benefit to the company through utilization against taxable income can nonetheless provide benefit by absorbing attribute reduction and allowing the survival of other valuable tax attributes. Interestingly, a carryover of disallowed business interest expense under section 163(j) is not an attribute subject to reduction.

In addition, the company has the option to elect to reduce the basis of depreciable property prior to reducing other attributes.[7] This is an attractive option to taxpayers that expect to generate significant amounts of taxable income in the years immediately following the restructuring, as the election to reduce depreciable property first generally allows NOLs and certain credit carryovers to survive and offset current taxable income in place of future depreciation deductions. As discussed below in more detail, this election is particularly attractive to taxpayers qualifying under section 382(l)(5).

Other relief provided in section 108

Section 108 provides additional relief that is worthy of note. CODI does not occur if payment of the cancelled debt would have provided a deduction to the company, pursuant to section 108(e)(2). This rule is typically when the forgiven liability is an expense accrued but not deducted.

1 Section 108(a)(1)(A). All references to "section" or "§" refer to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated under the Code.

2 Section 108(a)(1)(B), (a)(3).

3 Section 108(d)(3).

4 Section 1017(a).

5 Sections 382(l)(5) and (6).

6 Section 108(b).

7 Section 108(b)(5).

Section 108(e)(5) provides an exclusion where the CODI relates to debt issued to the seller of property from the purchaser. A common example of this is when a company is acquired utilizing seller financing such as a note from the purchaser to the seller. To the extent section 108(e)(5) applies, the basis of the acquired property is reduced by the amount of the CODI.[8]

Tax advantages of a bankruptcy reorganizations

A loss corporation (Lossco) will often benefit from a reorganization under Chapter 11 of the Bankruptcy Code where the company has significant NOLs or other attributes that could provide a future tax benefit post-emergence. However, the bankruptcy proceeding will in most cases result in an ownership change falling under the purview of section 382. For corporations undergoing an ownership change in a bankruptcy proceeding, sections 382(l)(5) and (6) (subsequently referred to as L5 and L6) provide favorable rules to help limit the impact of the change.

Section 382(l)(5)

In a bankruptcy workout that includes CODI, Lossco's attributes, including NOLs, are reduced through the provisions of sections 108 and 1017.[9] The benefit of an L5 workout is that section 382 does not apply to limit utilization of Lossco's NOLs or built-in losses (BILs) that survive attribute reduction.[10] As a result, under the right set of facts, the L5 transaction is preferred. However, certain conditions must be met to achieve this favorable application:

1. Lossco must be in bankruptcy immediately before the transaction.[11]
2. The shareholders and creditors of Lossco (determined immediately before an ownership change) must own (after the ownership change) 50% of the value and voting power of Lossco. [12]
3. Lossco cannot incur an ownership change under section 382 within two years following a change occurring during or as a result of the bankruptcy proceeding. Occurrence of a second ownership change will result in a limitation amount of zero following the second change.[13]
4. Lossco's creditors must have held their debt for at least eighteen months before the date that Lossco files for bankruptcy, or the debt must have arisen in the ordinary course of Lossco's trade or business and have been owned at all times by the same beneficial owner.[14]
5. The losses and excess credits carried forward from the three-year period before the ownership change must be reduced by the deductions taken for interest paid or accrued on debt exchanged for stock (the interest haircut).[15]

The following four examples help to illustrate the advantages and disadvantages of various debt workouts.

Example 1:
Assume Lossco has $500 million of NOLs prior to declaring bankruptcy, and $200 million of tax basis in depreciable property. In the bankruptcy, $300 million of Lossco's debt is discharged through the issuance of $100 million of equity to the debt-holding fund, yielding $200 million of CODI. Assume further that Lossco incurred $50 million of interest on the debt exchanged for equity. Lossco will have $250 million ($500 million less $50 million haircut and $200 million reduction) of NOLs available to offset taxable income without limitation. However, assuming Lossco elects to reduce its $200 million of depreciable property tax basis first, Lossco will have $450 million of NOL ($500 million less $50 million haircut) in available NOL.

However, in loan-to-own acquisitions where the PE acquired existing third-party debt, the fund is not a qualified creditor (because the fund does not satisfy the holding period requirement) and the transaction would fail to satisfy requirement 4 above; L5 would thus not be available. If, on the other hand, the debt acquired by the fund is newly issued, it is possible that the acquisition could qualify under L5; however, that is a highly fact-driven determination.

Section 382(l)(6)

Companies that elect out of L5 or do not qualify for L5 treatment instead apply L6. Lossco will typically elect out of L5 either because of a significant reduction to NOLs as a result of the interest haircut or, more often, because of the uncertainty surrounding the occurrence of a second ownership change, which would create a section 382 limitation of zero. Unlike L5, L6 provides that the section 382 limitation does apply to NOLs and certain BILs. However, under L6, the section 382 limitation is computed immediately after the ownership change and takes into account the increase in value attributable to the CODI. This recomputed value under L6, however, may not exceed the value of the assets before the ownership change.[16]

Example 2:
Assume that Lossco had assets with a value of $300 million immediately prior to the ownership change. After a $300 million discharge, assume Lossco had a value of $100 million. Assume further that Lossco also received an additional $200 million from the fund to finance growth and acquisitions. In this case, the value for purposes of computing the section 382 limitation is generally $300 million (i.e., the equity value prior to the change). The cash infusion by the fund in this case actually allows Lossco to increase the annual limitation. Lossco would have $200 million of NOLs following the attribute reduction, so ignoring built-in gains and assuming a 2% applicable rate, Lossco's annual limitation would equal $6 million per year. The $6 millinon ignores the effect that built-in gains would have on the limitation.

8 Section 108(e)(5).
9 See Sections 108(a), 108(b), 1017(a) and 1017(b)(2), and accompanying flush language.
10 Section 382(l)(5)(A).
11 Section 382(l)(5)(A)(i).
12 See sections 382(l)(5)(A)(ii) and 1504(a)(2).
13 Section 382(l)(5)(D).
14 Section 382(l)(5)(E)(i); Reg. section 1.382-9(2)(i)(B).
15 See section 382(l)(5)(B).
16 See section 382(l)(6), Reg. section 1.382-9(j). This means, for example, that new cash paid in for equity will not increase the section 382 limitation.

However, it is essential that Lossco consider the significant increases in the limitation that could result from recognized built-in gains. Under Notice 2003-65, 2003-2 C.B. 747, issued in 2003, the IRS provided taxpayers with two safe harbors to calculate the recognition of built-in gain, one of which is favorable to built-in gain companies. However, as noted above, this safe harbor may potentially be eliminated under regulations that were proposed in September 2019 but are not yet finalized or effective.

Nonbankruptcy workouts

Where the acquisition occurs out of court, the insolvency exclusion of CODI discussed above applies but the benefits of L5 and L6 do not apply. Accordingly, when CODI is triggered by a fund's exchange of Lossco's debt for newly issued equity in Lossco, the CODI incurred in the workout is excludable only to the extent of Lossco's insolvency.[17]

Example 3:
Under the same facts as the first example, assume further that Lossco was insolvent by $100 million and had assets with a value of $200 million. The $300 million discharge in exchange for $100 million of new equity results in $200 million of CODI. Lossco's taxable CODI is $100 million, which is the amount by which the $200 million CODI exceeded the $100 million of insolvency. Assuming the $500 million NOL was not limited prior to the workout, Lossco is allowed to offset the $100 million of included CODI prior to reducing attributes for the excluded CODI.[18] The remaining $400 million NOL is reduced by $100 million to $200 million under the attribute reduction rules. Lossco's value for purposes of computing the section 382 limitation amount is zero, as Lossco was insolvent immediately before the workout.

Taxable asset transactions

Workouts structured as taxable asset acquisitions, sometimes referred to as Bruno transactions (or Bruno's transactions, after a company that underwent this type of workout), involve a taxable asset sale by Lossco to its creditors in exchange for Lossco debt.[19] Following the exchange, the creditors contribute the assets to a new corporation or a new limited liability company (Newco). As a result, Newco obtains a cost basis in Lossco's assets equal to the FMV of the assets. Further, Newco does not succeed to Lossco's tax attributes such as NOLs or BILs, nor to its historic tax liabilities. To a buyer, the issues discussed above (i.e., relating to sections 108, 1017 and 382) have no effect on the continuing business. From a federal income tax perspective this is a straightforward transaction, and if the tax shield is similar to or greater than the tax shield from a more complex restructuring, this is the approach often chosen.

Creditors may pursue a Bruno transaction for both tax and nontax reasons. From a tax perspective, a Bruno transaction is beneficial where attribute reduction or the section 382 limitation would significantly reduce the benefit of NOLs and credit carryovers in the hands of the lender, and when the inside basis of Lossco's assets is significantly lower than their value. Although this analysis may seem counterintuitive, the leveraged buy-out (LBO) boom of the past few years and application of general corporate tax principles can have this result.

Example 4:
Under the same facts as the first example, assume further that Lossco was insolvent by $100 million and had assets with a value of $200 million. However, assume Lossco was acquired in an LBO that did not result in an inside basis step-up in the assets and that the inside tax basis of the assets was only $50 million. As we see in example 3 above, Lossco's NOLs will have little value to Lossco on a go-forward basis due to the section 382 limitation. However, by structuring the transaction as a taxable asset transaction, Newco will step up the basis of the assets to $200 million, which will provide an additional tax shield of $150 million beyond the existing tax basis. This is a much better result than the result found in Example 3.

Summary

As is apparent from the above examples, a company's particular circumstances will determine the most tax-efficient method of a debt workout. While companies and their creditors never intend on reaching the unenviable position of requiring a debt workout, attaining a favorable tax outcome can soften the situation's negative consequences. Considering the tax impact of these rules early in the restructuring process can result in a meaningful tax benefit. As the most advantageous transaction form is highly fact-driven, all workout options should be considered prior to moving forward with a workout plan.

17 Section 108(a)(3). See also section 108(d)(3) for the defining of insolvency for purposes of section 108.

18 Section 108(b)(4)(A).

19 In Re PWS Holding Corporation, Bruno's Inc., Case No. 98-212 through 98-223 (SLR) (Bankr. D. Del), Second Amended Joint Plan of Reorganization dated Oct. 15, 1999, Second Amended Joint Disclosure Statement dated Oct. 15, 1999.

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